

Contact: William R. Cline 202-328-9000
John Williamson 202-328-9000

June 3, 2009

DOLLAR AGAIN SUBSTANTIALLY OVERVALUED

WASHINGTON—A new study from the Peterson Institute for International Economics concludes that the dollar has again become seriously overvalued, principally though not exclusively, against the Chinese renminbi and some other Asian currencies. The “safe-haven effect” that caused a move into the dollar last fall resulted in a dollar appreciation of about 10 percent, which on top of an estimated overvaluation of about 7 percent a year ago made for an overvaluation of about 17 percent at the point of comparison (March 2009). Although the dollar declined about 5 percent from March to early June, it remains substantially overvalued. The principal counterpart to the overvalued dollar is the undervaluation of the Chinese renminbi, which would have needed to appreciate about 21 percent on a weighted average basis and about 40 percent against the dollar to achieve equilibrium.

The vast majority of the 29 currencies studied need to appreciate against the dollar. For example, the yen needs to rise to 82:1 against the dollar (as against 95 to the dollar recently) and the euro should appreciate to \$1.53 (as against \$1.40 recently). However, a large number of currencies show no great evidence of misalignment on an effective (i.e., trade-weighted) basis. This is true of the euro area, the United Kingdom, Japan, Korea, several Latin American countries, a number of Central and Eastern European countries, and several smaller Asian economies.

Establishment of an exchange rate pattern conducive to macroeconomic equilibrium requires substantial dollar depreciation and substantial appreciation of the renminbi and some other East Asian currencies like the Malaysian ringgit, the Singapore dollar, and the New Taiwan dollar, as well as a few others like the Swedish krona and the Swiss franc. This would be accomplished by most currencies appreciating against the dollar, with particularly large appreciations by China and the other countries whose currencies are mentioned above.

These are among the key conclusions advanced in *2009 Estimates of Fundamental Equilibrium Exchange Rates*, the second annual estimate of this type by Senior Fellows William R. Cline and John Williamson. They estimate fundamental equilibrium exchange rates (FEERs) for all the principal advanced and emerging-market countries, with the notable exception of countries whose exports are dominated by oil. They derive the present misalignment of each currency from a set of current account targets that generally do not exceed 3 percent of GDP. Adjustments to reach these targets are translated into needed exchange rate realignments against the dollar.

The principal results of the study are shown in table 1. The imbalances with greatest systemic significance are those of the United States (in deficit and overvalued) and China (in surplus and undervalued). It is critically important that as the world emerges from the current crisis these imbalances be corrected. Some economists believe that if the

governments achieve the needed changes in domestic spending and saving, then the appropriate exchange rate changes will automatically follow. Others, including the authors, believe that policy could usefully focus directly on achieving an appropriate exchange rate but we also concur that it is necessary for policy to aim at influencing domestic spending and saving in a complementary way. Indeed, the assumption that governments will do this is a key input to the analysis.

A number of desirable currency changes would be important to the countries themselves even if they do not carry great systemic significance. Switzerland provides a good example of a needed appreciation. The success of the Swiss authorities in driving down the Swiss franc in early March (*Financial Times*, April 24, 2009) has been welcome to those in Poland and Hungary who were so foolish as to take out mortgages denominated in Swiss francs but the world cannot be driven by such considerations. At the present level of the Swiss franc the very large international creditor position of Switzerland is destined to continue rising. It cannot rise indefinitely and the Swiss authorities would be wise to adjust before adjustment is forced upon them.

The only large countries that display large imbalances and therefore pose systemic threats are the United States and China. After the highly appropriate effective appreciation of the renminbi realized by sticking with the dollar during the latter's appreciation over most of the past year, it is important that China changes its peg from the dollar to a basket to stabilize the effective rate. Alternatively, it should resume the upward crawl of the peg against the dollar. Unfortunately the most recent evidence points in the other direction, as the policy over the past several months of keeping the renminbi unchanged against the dollar has remained intact despite the dollar's reversal toward a declining trend subsequent to its peak in early March. China has again begun to ride the dollar down.

Table 1 Currency realignments needed to reach fundamental equilibrium exchange rates (FEERs)

| Country/region | Percent change from March 2009 to reach equilibrium | | Recent dollar exchange rates | | |
|-------------------------------|--------------------------------------------------------|--------------------------------|---------------------------------|---------------------------------------------|--------------------------|
| | Trade-weighted average | Bilateral versus the dollar | FEER equivalent | Average of May 26 to June 2 ^a | Percent change needed |
| Industrial countries | | | | | |
| Canada | 2.4 | 7.6 | 1.18 | 1.11 | -6.2 |
| Euro area ^b | -0.9 | 17.1 | 1.53 | 1.40 | 9.0 |
| Japan | -1.2 | 19.2 | 82 | 95 | 16.4 |
| Switzerland | 12.7 | 28.9 | 0.90 | 1.08 | 19.8 |
| United Kingdom ^b | -0.6 | 16.2 | 1.65 | 1.61 | 2.7 |
| United States | -17.4 | 0.0 | 1.00 | 1.00 | 0.0 |
| Developing Asia | | | | | |
| China | 21.4 | 40.2 | 4.88 | 6.84 | 40.1 |
| Korea | -0.3 | 21.1 | 1,197 | 1,259 | 5.2 |
| Malaysia | 18.0 | 39.6 | 2.63 | 3.50 | 33.1 |
| Singapore | 10.6 | 33.5 | 1.15 | 1.45 | 25.9 |
| Taiwan | 13.8 | 36.4 | 25.2 | 32.7 | 29.7 |
| Other developing countries | | | | | |
| Mexico | -0.6 | 4.4 | 14.0 | 13.2 | -5.8 |
| Poland | -3.4 | 14.7 | 3.10 | 3.19 | 3.0 |
| South Africa | -13.2 | 5.0 | 9.48 | 8.12 | -14.4 |
| Turkey | -0.5 | 17.4 | 1.46 | 1.56 | 6.6 |

a. All days but June 2 are daily average; June 2 is opening value

b. Dollars per currency unit

ABOUT THE AUTHORS

William R. Cline, senior fellow, has been associated with the Peterson Institute for International Economics since its inception in 1981 and holds a joint appointment at the Center for Global Development. During 1996–2001 while on leave from the Institute, he was deputy managing director and chief economist of the Institute of International Finance in Washington. He was senior fellow, Brookings Institution (1973–81); deputy director of development and trade research, Office of the Assistant Secretary for International Affairs, US Treasury Department (1971–73); Ford Foundation visiting professor in Brazil (1970–71); and lecturer and assistant professor of economics at Princeton University (1967–70). His numerous publications include *Global Warming and Agriculture: Impact Estimates by Country* (2007) and *The United States as a Debtor Nation* (2005). He contributed to *The Long-Term International Economic Position of the United States* (2009).

John Williamson, senior fellow at the Peterson Institute, has been associated with the Institute since 1981. He was project director for the UN High-Level Panel on Financing for Development (the Zedillo Report) in 2001; on leave as chief economist for South Asia at the World Bank during 1996–99; economics professor at Pontificia Universidade Católica do Rio de Janeiro (1978–81), University of Warwick (1970–77), Massachusetts Institute of Technology (1967, 1980), University York (1963–68), and Princeton University (1962–63); adviser to the International Monetary Fund (1972–74); and economic consultant to the UK Treasury (1968–70). His numerous publications include *Reference Rates and the International Monetary System* (2007) and *Dollar Adjustment: How Far? Against What?* (2004).

ABOUT THE PETERSON INSTITUTE

The **Peter G. Peterson Institute for International Economics** is a private, nonprofit, nonpartisan research institution devoted to the study of international economic policy. Since 1981 the Institute has provided timely and objective analysis of, and concrete solutions to, a wide range of international economic problems. It is one of the very few economics think tanks that are widely regarded as “nonpartisan” by the press and “neutral” by the US Congress, it is cited by the quality media more than any other such institution, and it was recently selected as Top Think Tank in the World in the first comprehensive survey of over 5,000 such institutions. Support is provided by a wide range of charitable foundations, private corporations, and individual donors, and from earnings on the Institute’s publications and capital fund. It celebrated its 25th anniversary in 2006 and adopted its new name at that time, having previously been the Institute for International Economics.